TAX DIVISION

OF THE

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

STATEMENT OF

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TO

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COMMITTEE ON FINANCE

HOLDING HEARINGS ON

TAX SIMPLIFICATION

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INDEX

Introductory Comments

Mr. Chairman, and members of this distinguished committee, my name is Pamela J. Pecarich, and I am the chair of the Tax Executive Committee of the American Institute of Certified Public Accountants (AICPA). The AICPA is the professional association of certified public accountants, with more than 330,000 members, many of whom provide comprehensive tax services to all types of taxpayers including businesses and individuals, in various financial situations. Our members work daily with the tax provisions you enact.

You have heard from the AICPA many times over the last decade about the growing need for tax law simplification. While some reductions in complexity have been accomplished, we believe that a lack of attention to simplification in the legislative process and frequent changes to the tax law over the years have combined to significantly increase the size and complexity of the Internal Revenue Code. Few American taxpayers can understand and comply with the law without expending considerable resources. They have also lost respect for the tax system as it increasingly makes them victims of unintended consequences and outdated policies. The costly net result is eroded voluntary compliance. We continue to believe that citizens want to obey the tax law, but they can afford to spend only a limited amount of time and energy to understand and comply with the rules.

Fortunately, we face a unique opportunity. We are in a period of a budget surplus, and tax relief of some kind is imminent. We firmly believe that taxpayers are entitled to tax relief. But that tax relief can take many forms – a reduction in tax rates, additional incentives in the Code, or perhaps an overall reduction in the costs of compliance, both financial and psychological. In fact, the time is right for relief through tax simplification. Simplification has become an economic, political, and even moral imperative.

As Congress considers how to allocate the limited resources available for tax relief, we urge that priority attention be given to: fixing structural problems that have grown and existed in the tax system for too long; focusing resources on simplifying aspects of the tax law that trouble the largest number of taxpayers; and, avoiding further harm to the system through unnecessary complexity.

The time has past for merely applying "bandaids" as temporary fixes to structural problems. Although attempting comprehensive simplification of the entire Code may be unrealistic, focused simplification efforts on particular portions of the Code could rationalize existing law, as well as introduce new policy goals and initiatives in a manner consistent with an overall framework. A perfect example of an area that has become outdated and grown into a structural problem is the alternative minimum tax -- a provision originally intended for a narrow group of the highest income taxpayers. The projected number of individual, middle income taxpayers who will be caught in the AMT trap over the next few years is staggering. The time to fix this problem is now, especially as Congress is considering an across-the-board tax cut which would compound the AMT problem exponentially.

Next, there are many complex areas of law affecting a large number of not particularly sophisticated taxpayers. A concerted simplification effort in any of these areas would go a long

way toward easing compliance burdens. Areas that could benefit greatly from simplification include the earned income tax credit, education credits, the child credit, retirement savings provisions, and even expensing versus capitalization rules which affect a significant proportion of businesses.

Congress can avoid further harm by giving simplification a prominent position in the tax process on an on-going basis. The process of considering new tax legislation must include a complexity analysis of every proposal and a simplification review of existing law in the area under consideration. Although simplification should not take precedence over revenue and tax policy objectives, it must be an equal and integral part of the legislative, regulatory, and administrative process. Collectively, we must learn to accept "rough justice" in return for a more viable tax system.

We recognize that a tax system that is "simple" for all taxpayers may never be achieved, but we do believe that a "simpler" system is attainable. Now is the time to move toward this simpler system.

The Legislative Process and Tax Simplification

The AICPA has long advocated tax simplification. We were greatly pleased when many of the concepts and factors identified in our *Blueprint for Tax Simplification* and *Complexity Index* were incorporated into the tax law complexity analysis mandated by the Internal Revenue Service Restructuring and Reform Act of 1998. We were also pleased that the independent role of the National Taxpayer Advocate was strengthened and enhanced.

In the Annual Report to Congress for fiscal year 2000, the Advocate confirmed that tax law complexity "remains the number one problem facing taxpayers, and is the root-cause of many of the other problems on the Top 20 list." The Advocate's concern about complexity has become so severe that complexity is now ranked number one *and* number two on the Taxpayer Advocate's list of the 20 most serious problems facing the U.S. tax system.

"Despite IRS restructuring to target services to taxpayer needs," the Advocate's report states, "the fact remains that the Internal Revenue Code is riddled with complexities that often defy explanation.... [therefore, the Advocate suggests that] Congress take actions to simplify the Internal Revenue Code and make it easier to understand and implement." As you review the AICPA's simplification recommendations, you will see many parallels to the recommendations of the Taxpayer Advocate.

The 1998 Act established a framework for analyzing complexity, and since enactment, much work has been done to develop the tools to measure a proposal's incremental complexity. In addition, we look forward to reviewing and commenting on the Joint Committee on Taxation's just-completed study on complexity.

The next step must be to use these tools to evaluate the proposals currently before Congress. Legislators and staff must commit to considering the relative complexity of competing proposals

and to meeting policy goals in the "simplest" manner possible. This final element is critical to achieving the simplest tax system possible for the most taxpayers.

Recent Legislative Proposals

In recent years, tax legislation has been enacted more frequently and has increasingly relied on thresholds, ceilings, income tests, eligibility rules, phase-ins, and phase-outs – all of which complicate compliance. In addition varying effective and sunset dates are used to target benefits to numerous specific taxpayer groups within set revenue constraints. Although well intentioned, these targeted benefits sacrifice simplification. Cumulatively, targeted provisions further weigh down our tax system with complexity and impose very real compliance costs.

The Administration's fiscal year 2002 tax relief proposals continue this trend through a five-year phase-in of many of the key provisions and the addition of new, targeted provisions -- i.e., reducing tax rates, increasing the child tax credit, reducing the marriage penalty, and providing a charitable contribution deduction for non-itemizers. Simpler solutions are attainable in order to accomplish the desired policy goals. We firmly believe that the goal of reduced complexity must be balanced with the other policy goals underlying the provisions.

Providing some balance, the Administration's fiscal year 2002 tax relief proposals also contain provisions to permanently extend several tax credits, such as the research and experimentation tax credit and the adoption tax credit. Without taking a position on the underlying policies, we applaud the effort to bring the "expiration and extension cycle" for these provisions to an end. Unfortunately, the Administration's proposals also include only a one-year extension for multiple provisions that will expire in 2001, such as the exclusion of employer-provided educational assistance. Short-term extensions of broadly applicable provisions cause administrative difficulties for the IRS and taxpayers, making it impossible for taxpayers to plan with any degree of certainty.

Complexity is manifested in Code provisions that contain vague or highly technical requirements, often with exceptions, limitations, and other special rules that even the most sophisticated tax advisers can find difficult, if not impossible, to decipher. Add to this the many provisions -- complex in their own right -- that must be applied in tandem with other complex provisions. Even if a complex provision works appropriately standing alone, when coupled with another equally complex provision, the result may be simply incomprehensible. Constant changes and amendments to the tax laws, accompanied by effective date and transition rules, breed complexity as well as uncertainty, confusion, and frustration. Since 1995 there have been 2,116 tax law changes. Statutory change spawns a steady stream of new, and often voluminous, Treasury regulations, which require an enormous expenditure of IRS and Treasury intellectual capital. This is clearly demonstrated by the explosion in the number of pages in the Code and regulations from 19,500 in 1984 to 45,662 in 2001.

We recognize that most complex Code provisions have laudable goals. In many cases, however, the burdens imposed on taxpayers and the Internal Revenue Service quite simply outweigh the benefits of attaining those underlying goals in that particular manner. Further, original, worthy goals are often superseded by changes in society or the economy, or by other changes in the law,

resulting in complex provisions that no longer serve their intended purpose. Yet, these provisions remain in the law.

We encourage Congress to fundamentally change the way it considers tax legislation and the priority it gives to tax simplification.

ABA, AICPA and TEI Joint Effort to Simplify Existing Tax Law

The AICPA is not alone in its concerns about tax law complexity. Over the past several years, we have been pleased to join with the American Bar Association Section of Taxation and the Tax Executives Institute in working toward the common goal of simplifying and rationalizing our tax system. In collaboration with our professional colleagues, we developed a package of tax simplification recommendations that we first submitted to Congress on February 25, 2000. A copy of our proposals is attached as Appendix A. Please note that we are in the process of updating the package and it will be resubmitted in several weeks. Many of our recommendations are in areas are also recommended for action in the Taxpayer Advocate reports to Congress over the last two years.

These recommendations are not exhaustive; rather, they are merely a starting point. Neither are the proposals are listed in priority order. Action in any of these areas will go a long way toward simplifying the tax system for many individual and business taxpayers. In my testimony today, there are several areas on which I would like to focus your attention.

Eliminate or Rationalize Phase-Outs

Many Code provisions confer benefits on individual taxpayers in the form of exclusions, exemptions, deductions, or credits. These provisions, many of which are complex in and of themselves, are further complicated because the benefits are specifically targeted to low- and middle-income taxpayers. Targeting is accomplished by phasing out benefits when individual or family income exceeds certain levels. As you will see from the chart included as Appendix B, phase-outs are used throughout the Code, without any consistency in the measure of income, the ranges of income over which they apply, or the method of application. In short, the Code lacks a coherent, consistent framework for defining, providing or denying tax benefits to low-, middle-, and upper-income taxpayers.

Phase-outs result in a significant number of problems, including:

- creating hidden tax increases and irrational marginal tax rates;
- adding significantly to the length of tax returns;
- increasing the potential for errors;
- being difficult to understand; and
- obscuring whether the promised benefit will ultimately be available.

CPAs regularly -- and all too frequently -- encounter taxpayers frustrated and angered by the loss of an anticipated benefit because some unforeseen factor or phase-out rule denies them eligibility. Often this discovery occurs only after the tax return is filed, and possibly not until the IRS proposes an adjustment or penalty.

Examples: Attached as Appendix D is an article from the March 2001 *Journal of Accountancy* titled "Stealth Taxes – The Real Cost of Hidden Tax Traps". It contains examples demonstrating how various limitations and AGI tests interact to create virtually unpredictable tax consequences in a variety of common circumstances.

A recent example that came to our attention involved a contribution to an Individual Retirement Account by a taxpayer whose wife was a participant in an employer pension plan. The couple filed an extension for their personal tax return on April 15th, but subsequently received a Form K-1 for the wife with a larger than expected amount of partnership income. This additional income unexpectedly put the couple over the phase-out level for a deductible IRA contribution.

Another member exclaimed after this filing season, "How could a typical taxpayer possibly remember or understand the rules about how much or whether contributions can be made to a traditional IRA, a Roth IRA, a nondeductible IRA, or an education IRA?"

Recommendations: Simplification could be achieved by eliminating phase-outs altogether and standardizing income limits and eligibility rules. Alternately, substituting cliffs for phase-outs would reduce complexity, as would providing consistency in how income is measured and standardizing phase-out ranges and methods.

Harmonize and Simplify Education Incentives

Since 1997, Congress has provided numerous education incentives and tax benefits for students and parents. There are currently eight different "education incentive programs" in the tax law including tuition credits, education IRAs, deductible state tuition prepayment programs, income-limited deductions on student loan interest, and tax-favored employer-provided education assistance programs. Attached as Appendix C is a table highlighting the myriad of eligibility rules for these programs. The Administration has proposed expanding education savings accounts and increasing the annual contribution limit over five years. Rather than adding more rules to an already overly complex area of tax law, Congress should consider a comprehensive overhaul of all these provisions to accomplish the desired policy goals and at the same time harmonize and simplify the tax system's existing education incentives.

In our experience, education incentives are an area where the rules are so cumbersome in comparison with the benefits received that many taxpayers choose to forego the benefit. Other taxpayers, who struggle through the complicated rules to take advantage of the benefit, may ultimately find that some unforeseen factor makes them ineligible. The incentive goal of provisions enacted to spur education is lost due to the complexity.

Examples: Eligibility for one of the education credits depends on the academic year in which the child is enrolled, the timing of tuition payments, the nature and timing of other eligible expenditures, and the adjusted gross income level of the parents or, possibly, the student. In any given year, parents may be entitled to different credits for different children. In other years, credits may be available for one child but not another. The education credits are dependent on the income levels of the parents or the child attempting to claim them. Further complicating the

scheme, the Code precludes using the Lifetime or Hope Credit if the child also receives benefits from an education IRA. Although a child can elect out of education IRA benefits, this decision entails additional analysis and complication.

A tax professor recently recounted his students' confusion over education credits. Particularly troubling for the students was that they attend school by an academic year, but the credits are calculated on a calendar year basis. For example, in the spring semester of the second year of college, a student is still in the first year of the two-year eligibility for the Hope Credit. But in the fall semester of that same calendar year, the student is in their third year of college for the Lifetime Learning Credit. Because both credits cannot be used in the same *calendar* year, which should they use? The answer to this tax conundrum is definitely not clear and often a wrong decision is made.

Five of the eight educational provisions are complicated by eligibility phase-outs based on various AGI levels. Thus taxpayers must make numerous calculations to determine eligibility for each of the various incentives. By failing to satisfy all the many individual tests required for each benefit, taxpayers may inadvertently lose the benefits of a particular incentive because they either do not understand the provision or they pay tuition or other qualifying expenses during the wrong tax year.

Separately, college graduates are entitled to deduct a portion of interest paid on their student loans. However, this deduction is reduced or eliminated as AGI exceeds certain thresholds. In turn, these phase-out thresholds differ from the education credit and education IRA thresholds.

With tax filing season fresh in our memories, our members recount stories of taxpayers who found themselves ineligible to use an education incentive because of an unanticipated factor. This tax season's major culprit has been the recognition of unanticipated capital gains at year-end, brought on by the stock market's sharp rise and steep fall. Many middle-income taxpayers who planned on help with their child's education costs are now finding out that their hard work to understand and comply with the rules was for naught because of this unexpected income recognition.

Recommendations: Simplification suggestions for higher education tax incentives include:

- combine both existing education credits into one;
- simplify the definition of "student;"
- establish a single amount eligible for the credit;
- eliminate or standardize the income ranges required for eligibility;
- in lieu of the credits, grant additional exemption amounts to taxpayers who qualify for the credit under current law;
- ease the interest deduction requirements and coordinate the phase-out amounts with other education incentives; and
- replace current tax benefits with a new universal education deduction or credit.

Repeal the Alternative Minimum Tax

The individual AMT no longer serves its intended purpose. Rather, it produces enormous complexity and has unintended consequences. Enacted in 1969 to address concerns that persons with significant economic income were paying little or no Federal tax, the AMT today has little effect on its original target and increasingly affects an unintended group of taxpayers – the middle class. These taxpayers generally find themselves unexpectedly subject to the AMT, not because they "overused" specialized tax preferences, but because of ordinary use of personal exemptions, the standard deduction, state and local taxes, or miscellaneous itemized deductions.

Examples: This problem is exemplified by stories from a CPA helping out at a volunteer tax clinic. A single mother of five who earned only $45,000 found herself subject to $1,850 of AMT because the number of personal exemptions triggered the AMT. To further add to her tax woes, this struggling mother did not qualify for the child care credit. In another case, a combination of unusual events subjected a couple to AMT. An unexpected capital gain and a large emergency medical expense resulting from being medically evacuated from Africa combined to trigger the AMT. In these and in much less dramatic circumstances, the AMT continues to surprise taxpayers and their advisors by the unpredictability of its application.

Recommendations: Other changes to the Code since 1969 that limit tax shelter deductions and credits now achieve the result originally intended for the AMT. Repealing the individual AMT would accomplish significant simplification in one fell swoop. The past and present Taxpayer Advocate strongly support AMT repeal. Further, the corporate AMT suffers from the same infirmities as the individual AMT and should be repealed as well.

Simplify the Rules for Taxation of Capital Gains

The capital gains regime for individuals has become excessively complex as a result of numerous expansions and adjustments. Although each item of fine-tuning may be defensible in isolation, the cumulative effect has been to create a structure that is incomprehensible both to taxpayers and to the people who prepare their returns.

The problem is exacerbated by the large number of taxpayers now affected; compliance with capital gains rules no longer concerns just the wealthy. Almost half of the American people now own stock, and due to the stock market's sharp rise and steep fall, the 2000 tax year will be the biggest capital-gains tax year in history. The Congressional Budget Office estimates that roughly 12 percent of all individual income tax receipts for the year will come from capital gains -- double the percentage of a decade ago.

Further, the current system imposes significant record-keeping and reporting burdens on taxpayers. According to the IRS's own measure of this increased reporting burden, in 1990 the average taxpayer spent an estimated 3 hours and 18 minutes completing Schedule D to report capital gains. Just 10 years later that estimate has more than doubled to 6 hours and 58 minutes.

Examples: A CPA recently put this issue in perspective for me. A friend had prepared his own tax return by hand. He reported several stock and mutual fund transactions on the front page of Schedule D, with nothing novel like collectibles, small business stock, or recapture of real estate depreciation. The friend had not, however, completed the back of the form to compute the 20 percent tax on his long-term capital gain. When asked "why not", the friend acknowledged that, although he knew it would save him taxes, it was just too complicated to bother. Clearly here the burden of complexity outweighed the intended tax benefit. All too often CPAs are encountering taxpayers who choose to forgo a tax benefit because the compliance cost, both financial and psychological, is too high.

Despite the already excessive complexity associated with capital gains taxation, additional complexities continue to be added. For example, a special rule now permits taxpayers holding property acquired before 2001 to elect to have the property treated as if it had been sold on the first business day after January 1, 2001, thereby becoming eligible for the special 18 percent rate if it is held for another five years. Additional confusion results because this special rule applies immediately for those in the 15 percent bracket, but can be elected by those above the 15 percent bracket. Determining whether to make this election will require taxpayers to make economic assumptions and do difficult present value calculations.

Recommendations: Capital gains taxation should be simplified by establishing a single preferential rate and a single long-term holding period for all types of capital assets.

Clarify Rules Governing Expensing, Capitalization and Recovery of Capitalized Costs

Another area in great need of simplification is the capitalization or expensing of costs. The tax treatment of some business expenditures depends on whether they are classified as "period" expenses, and therefore deductible in the current year, or expenses which must be capitalized. In which case, they are either deducted over time as the asset depreciates or when the asset is sold. This classification depends on whether the expenditure produces a "future benefit." But, that determination is rarely obvious or easy.

The enormous drain on both government and taxpayer resources to make these determinations must be alleviated. The IRS and Treasury should be required to issue guidance setting forth objective, administrable tests on recurring and routine deductible business expenses and to create clearly defined categories of capital expenditures.

Additional Areas in Need of Simplification

As noted earlier, I have attached a full package of recommendations jointly developed with the ABA Tax Section and TEI as Appendix A to my written testimony. Additional areas in need of simplification covered in the package include:

Simplify and harmonize the definitions and qualification requirements associated with filing status, dependency exemptions, and credits – Family status affects various tax provisions designed to accomplish different ends. Family status issues are further complicated by the increasing number of non-traditional families -- a phenomenon that cuts across all income levels. Given the multiple policy considerations underlying the family status provisions, uniform definitions alone may not achieve optimum simplicity. It is possible, however, to simplify and harmonize the eligibility criteria for many of these provisions and establish safe harbors to provide taxpayers with more certainty and comfort.

Rationalize estimated tax safe harbors – The availability and computation of the prior-year safe harbor for estimated taxes has been adjusted repeatedly during the past decade. This has resulted in considerable confusion and complexity for a significant number of individual and small business taxpayers. An appropriate safe harbor percentage (perhaps 100%) should be determined and applied for all years. Enacting a meaningful safe harbor would also simplify estimated tax computation and compliance for all corporations.

Make expiring provisions permanent – The need to extend expiring provisions adds confusion and, in many cases, undermines the policy reasons for enacting the incentives in the first place. The on-again, off-again nature of these provisions, coupled in some cases with retroactive enactment, contributes significant complexity. Significant incentive provisions should be enacted on a permanent basis.

Change the half-year conventions for retirement plan distributions to full-years – The Code provides that retirement plan benefits must commence, with respect to certain employees, by April 1 of the calendar year following that in which the employee attains age 70 ½. It also provides that plan benefits may not be distributed before certain stated events occur, including attainment of age 59 ½. The half-year age conventions complicate retirement plan operation because they require employers to track dates other than birth dates. Changing the age requirements to 70 from 70 ½ and to 59 from 59 ½ would have a significant simplifying effect.

Simplify the minimum distribution rules for retirement accounts – The tax rules concerning retirement plan distributions are among the most complex in the Code and present numerous traps for the unwary. Further, an ever-growing percentage of Americans are now in or approaching their retirement years. Untold millions of retirement accounts will soon become subject to these rules. Simplification is badly needed.

Replace the 20-factor common law worker classification test –Whether a worker is an employee or independent contractor is a particularly complex determination using a 20-factor common law test. Each of the factors is subject to interpretation, and there is precious little guidance on how or whether to weight them. In addition, the factors do not apply in all work situations and do not always result in a meaningful indication of whether the worker is an employee or independent contractor. This complex and highly uncertain determination should be eliminated and replaced with a more objective test applicable for Federal income tax and ERISA purposes. Alternatively, changes could be made to reduce differences between the tax treatment of employees and independent contractors. Judicial review by the United States Tax Court of worker classification disputes should be available to both workers and employers.

Harmonize attribution rules – The attribution rules throughout the Code contain a myriad of distinctions. While perhaps reasonably fashioned in light of the particular underlying concern at the time enacted, the attribution rules should be reexamined with the objective of harmonizing and standardizing them.

Simplify the foreign tax credit rules – The core purpose of the foreign tax credit (FTC) is to prevent double taxation of the same income by both the United States and a foreign country. Although these rules may never be truly simple, action can be taken to temper the extraordinary complexity of the current regime. At a minimum, Congress should act to: consolidate the separate baskets of income for businesses that are either starting up abroad or that constitute small investments; and, eliminate the alternative minimum tax credit limitations on using the FTC. Accelerating the effective date of the look-through rules for dividends from so-called 10/50 companies should also be considered.

Simplify application of Subpart F – In general, 10-percent or greater U.S. shareholders of a controlled foreign corporation (CFC) are required to include certain income of the CFC (Subpart F income) in current income. The Subpart F rules were created almost four decades ago, and sorely need updating to deal with today's global economy in which companies are centralizing their services, distribution, invoicing, and often manufacturing operations. Substantial simplification could be achieved through basic measures, including exempting smaller taxpayers or smaller foreign investments from the Subpart F rules; excluding foreign base company sales and services income from current taxation; and treating European Union member states as a single country for purposes of the same-country exception.

Limit application of the passive foreign investment company rules – In 1997, the passive foreign investment company (PFIC) rules were simplified by eliminating the CFC-PFIC overlap and allowing a mark-to-market election for marketable stock. However, a great deal of complication remains, and further simplification is necessary. We recommend, for example, that Congress eliminate the application of the PFIC rules to smaller investments in foreign companies whose stock is not marketable.

Repeal the collapsible corporation provisions – The repeal of the *General Utilities* doctrine in 1986 rendered IRC section 341 redundant. It is deadwood and should be repealed. As an additional incentive, its repeal would result in the interment of the longest sentence in the Internal Revenue Code

The AICPA and our professional colleagues will continue to develop additional simplification recommendations and to refine the recommendations detailed above.

Conclusion

I would like to again stress that NOW is the time to enact meaningful tax simplification relief. Congress must take advantage of the unique opportunity presented by a budget surplus in a year when broad support exists for tax relief. In allocating the limited resources available for tax relief, Congress must give priority attention to fixing structural problems, focusing on areas

troubling large numbers of taxpayers, and avoiding the further harm of adding complexity to the tax system.

I greatly appreciate this opportunity to share the AICPA's views and thoughts with you today. As always, the AICPA stands ready to provide whatever assistance and support this Committee may find helpful in its critical task of simplifying our tax laws.